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PROVIDING SUSTAINABLE FINANCIAL AND NON-FINANCIAL SERVICES FOR SME DEVELOPMENT

Issues paper by the UNCTAD secretariat

Executive summary

There is a broad consensus on the signficance of entrepreneurship as the driving force of the SME sector, and on the recognition that for SMEs and entrepreneurship to flourish they need the right conditions. This requires bringing the specific needs of the enterprise to the centre of policy-making, and the recognition that SMEs are to be assisted not just because they are small, but because of their capability/potential to be efficient, innovative and able to compete in the national marketplace, as well as internationally. Different processes - i.e., progressive de-verticalization of industrial production, privatization and liberalization - have opened up new market niches which small companies have the potential to exploit.

However, lack of entrepreneurial and technical skills, insufficient management and commercial know-how, and lack of adequate equipment and facilities (i.e., "internal" constraints), limited access to information on markets, innovative production processes and technology, restricted access to credit and finance (i.e., "access" constraints) are all factors which marginalize small local producers and largely exclude them from participating in the global markets. To overcome these obstacles, high-quality technical and consultative services need to be provided by support systems or infrastructure, so that local SMEs - which rely on external inputs much more than large-scale firms - are able to compete and adjust to a rapidly changing domestic and international economic environment.

In particular, five core business services can be identified, representing key strategic elements for increasing firm-level competitiveness: computer software and information processing services, research and development and technical services, marketing services, business services, and human resource development services. This assertion clearly challenges the common belief - known in the literature as the "minimalist approach" - which holds that access to finance is all entrepreneurs need to succeed. The current emphasis on non-financial services argues instead that finance is necessary for SME development, but not sufficient.

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PROVIDING SUSTAINABLE FINANCIAL AND NON-FINANCIAL SERVICES FOR SME DEVELOPMENT

Preface

During its first session, the Commission on Enterprise, Business Facilitation and Development recognized the crucial role played by small and medium enterprises (SMEs) in stimulating broad-based, equitable and sustainable development, as well as the role of the changing global economic environment and the pressures this puts on SMEs. In the light of the above, the Commission, at its third session (23-27 November 1998), agreed to convene an expert meeting on the "Development of sustainable local services and national and international support measures including financial and non-financial services, human resource development, access to information and an assessment of access to technologies, to improve and promote SME development in developing countries". This issues paper provides background information on best practices in providing services and access to information, technology and finance, in order to stimulate fruitful discussions during the meeting.

Introduction

1. Many industrialized and developing countries are implementing policies for promoting and supporting SME development. They commonly recognize that these enterprises require only modest amounts of capital to generate proportionately greater employment, spread economic activity throughout the country and help to distribute the benefits of economic development. As a result, diverse programmes have been initiated to further SME development. These include:

(a) Adopting the appropriate economic policies to stimulate SMEs and remove impediments to their growth;

(b) Setting up legal and fiscal frameworks to protect small businesses;

(c) Increasing access of SMEs to institutional finance;

(d) Supporting the creation of business development services (BDS) to assist small enterprises to overcome market imperfections and the lack of access to technology and information, and to enable them to compete more effectively.

2. This paper addresses both financial and non-financial support measures. Chapter I focuses on best practices in the delivery of non-financial services, or BDS. Special attention is given to effective mechanisms for helping SMEs to access and upgrade technological know-how. Additionally, new challenges arising from rapid development in information and communication technologies are discussed. In the era of global competition, knowledge and its communication have become essential factors of production along with capital and labour, and are increasingly applied to all phases of the production process. Chapter II concentrates on financial topics: key obstacles to access credit, solutions that have already been identified, and additional practical measures that could effectively complement existing solutions.

CHAPTER I

BEST PRACTICES IN THE DELIVERY OF NON-FINANCIAL SERVICES

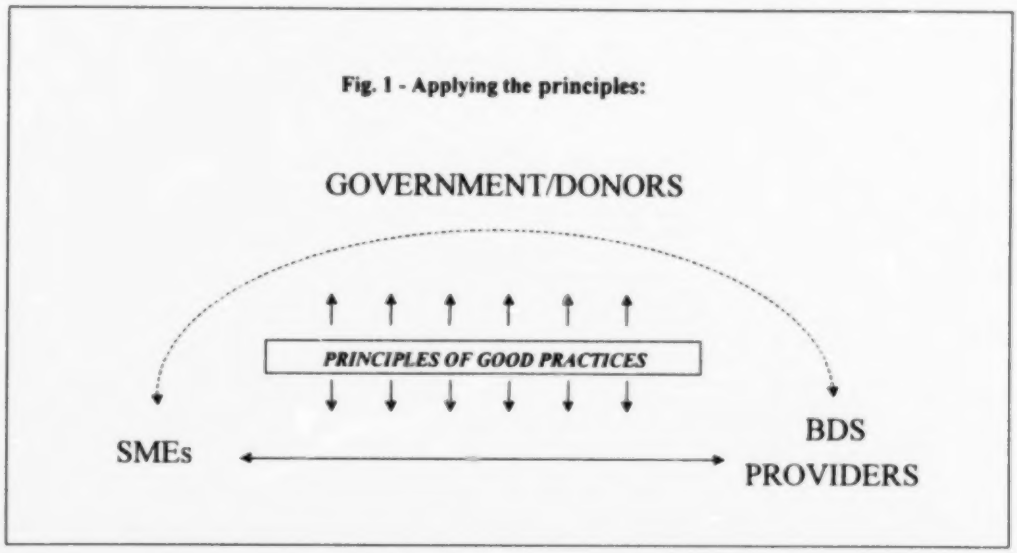
A. Creating an effective BDS industry

3. There are important objective requirements in the organization of the delivery of BDS. Until now experience with BDS has consisted mostly of publicly supported services, generally in the field of training, marketing and technology-related areas, but these have not proven very successful. Poorly staffed and badly managed, many have proved costly and have benefited only a small number of enterprises in limited geographical areas. These BDS, often provided by government agencies and para-statal institutions, have offered supply-driven services without assessing the true needs of the SME sector.

4. It is now recognized that modern and effective demand-driven BDS are required by the small enterprise sector, and accordingly most of the specialized government and donor agencies are engaged in the complete restructuring of the SME support system. Unfortunately, unlike financial services, which are easily evaluated in terms of loan take-up and pay-back, the performance of BDS has never been evaluated in a comprehensive, systematic way. Only recently have a number of core principles of good practice emerged, thanks to the efforts of international donors and government agencies, scholars and practitioners with "hands-on" experience. Among these principles:

- demand-side orientation and adaptation to users' needs;
- subsidiarity (who can do what best);
- focused, strategic and collective approach;
- market-oriented and businesslike;
- cost recovery;
- cross-subsidization of services and clients;
- sustainability (financial and institutional);
- monitoring and performance measurement.

Fig. 1 - Applying the principles:



5. *Demand-side orientation and adaptation to users' needs.* It is extremely important to instigate a dialogue with SMEs, help them identify and evaluate their own needs, and strengthen their linkages with local service providers and support institutions. From the methodological point of view, evidence of past efforts has shown that often the *subsectoral approach* has greater relevance and achieves greater success in focusing assistance and advisory services on the common technological and marketing problems faced by the enterprises, which means targeting the intervention to the local productive system rather than to the individual small producer. Such subsectoral approaches can provide services in a more cost-effective manner where the range of beneficiaries from the same subsector have common problems in organizing production, and marketing and face similar technical difficulties that can be handled by collective action. In some instances, where small businesses tend to locate close to each other, BDS have developed common administrative, marketing, purchasing or information services or common computer or technical facilities, tailored to local needs.

6. *Focused, strategic and collective approach.* Experience shows that BDS can be extremely cost-effective when provided to clusters of small businesses operating in close geographical proximity, and can provide unique opportunities for fostering or strengthening links between small enterprises themselves. As a matter of fact, where the local productive system is characterized by a high level of inter-firm linkages, basically through customer/supplier relations and formal and informal subcontracting agreements, a virtuous cycle can be perpetuated only if all parts of the system perform in an efficient, innovative, dynamic and flexible manner. It can be said that "efficient firms allow other firms in the system to purchase inputs more cheaply; dynamic and innovative firms enable other firms to keep up with the latest technology and creative ideas; flexible firms providing quick responses speed up the capabilities of all firms which have supplying or subcontracting relations with them". [1] Furthermore, to ensure that the whole cluster or network of firms retains such collective capability and maintains the competitive edge, it is necessary to ensure a trend of continuous improvement. Technical service centres can monitor, lead and coordinate these improvements.[2]

7. *Subsidiarity.* Bearing in mind the time pressures on SMEs, BDS must be brought as physically close and made as convenient as possible for the small-scale entrepreneur. This requires the maximum feasible *vertical and territorial decentralization* in organizing BDS as conditions permit. Where BDS are already known, consolidated and requested by the market, government institutions should not be direct service providers but should make indirect use of local support structures. Where BDS are strategically important but not yet adapted to local needs, joint efforts by public and private institutions have proven effective institutional responses. Approaches of recent years have concentrated, particularly in larger countries, on the creation of

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1 J. Dawson (1997).

2 Although clusters are generally the result of a spontaneous tendency for SMEs in the same or similar sub-sectors to locate close to each other, there are also organized efforts to set up *technical incubators* or industrial parks - the grouping together of "start-ups" of small businesses usually based on more advanced technologies. Often situated close to universities or research institutes, they benefit from the technological advice and help of faculty members as well as more practical administrative support services and, in many cases, interchange with other scientifically or technically minded entrepreneurs. Incubators and industrial parks are spreading from a number of locations in the United States and Western Europe to South-East Asia, Latin America and some countries in transition. With suitable help in the form of technological assistance, venture capital and a stimulating environment, selected scientifically or technically qualified entrepreneurs can succeed in setting up SMEs which will produce items with a high technological content.

business support centres in various regions and localities of the country where they could be justified by the number of potential beneficiaries. Generally speaking, they are one-stop centres, sometimes sectorally specialized, where entrepreneurs have access to a whole set of services and inputs (i.e., entrepreneurship training, information, finance, quality control, design, networking, and consultancy) needed to grow their businesses and face increasingly competitive external pressures. As already explained, outreach and cost-effectiveness can be maximized when operating within a pre-determined target group in a circumscribed area.

8. *Market oriented and businesslike*. Because of past limitations and failures of public agencies in delivering BDS, more and more attention is now being paid to the possibility of increasing the *participation of the private sector* in offering SME services. The private sector in this case includes trade or industry organizations, such as chambers of commerce and business associations but it may also include semi-public institutions, private consultants and non-governmental organizations (NGOs). In some cases, direct linkages can be fostered between larger corporations which are prepared to offer assistance and advice and small businesses. This can be either through commercial or trading links such as subcontracting or franchising or by the large corporation acting as a supplier of primary or intermediary materials which leads to the provision of advice and help to the smaller firms. It may also take the form, as in some countries, of organized formal regional links between groups of larger companies, such as has taken place in the United Kingdom and some of the countries of Eastern Europe, or in the creation of enterprise agencies or other types of associations, such as exist in Kenya or South Africa, to give but two examples. In some Asian countries, schemes have been developed with some success for the adoption of small firms by larger "foster parents" which are available for assistance and advice on a whole range of issues and problems.

9. *Cost recovery*. BDS are costly, especially if consultancy or extension services are offered on a one-to-one basis. As has already been indicated, some of the costs can be reduced by providing services to groups of similar businesses in the same sub-sector or located close to each other. Where *subsidies* are needed, as may be the case in the early years of a BDS development process, these should be transitional and proportional to the viability of the firms assisted. The more businesses benefiting from the service evolve and "graduate", the more they should meet part of the expenses. [3] The question of subsidies, both for training and for technical and advisory services has been widely discussed. There is no doubt that there is a greater commitment on the part of those who participate in a training course or support programme if they have themselves had to pay, at least in part, for their participation. On the other hand, for very small and micro-businesses, there is a strong case for some form of subsidy to cover part of the fee provided that there is some contribution from the participant. [4] In general, the need for and efficacy of BDS are hard for

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3 In some Latin American countries, Enterprise Development Centres have been set up in certain localities with the help of the Inter American Development Bank and subsidize the costs of providing the consultancy service. In the early stages of the programme, a greater proportion of the costs are subsidized from funds from donors and Governments, and these proportions are reduced as the programme progresses. From the start, the enterprise benefiting from the consultancy has to pay at least some of the fee to cover the cost of the services. The Centre, for its part, selects and approves accredited consultants, while the enterprise requesting the assistance may then choose one of those from the accredited list. It is generally understood that a consultant selected from the list is suitable as regards background and approach and has agreed to offer services at a relatively modest fee.

4 A great deal of interest has been shown of late in the *use of vouchers*, the cost of which is financed from public or external donor funds, covering a proportion (usually around 50 per cent, but sometimes more) of the costs of the training programme. These vouchers can then be issued on a selective basis to those who will make their own matching

SMEs to judge initially, and so there might be a reluctance to pay. In order for BDS to reach increasing levels of cost recovery, small businesses must improve profitability and productivity through the services, which makes SMEs willing to pay higher prices to access additional services. As a consequence of the "demonstration effect" new clients may also demand the services, and they may be willing to pay higher prices from the start, or may still need to be subsidized until they experience the benefits directly. In any case, both steadily increasing cost recovery and the size of the client base can be considered as indicators of the success of BDS providers.

10. *Cross-subsidization services and clients.* It should be noted that cost recovery is easier for some services than others. Some BDS, such as marketing, technology, accounting and legal services, have clearly proven their potential profitability, or financial viability. Other services, such as access to information and training, are not as profitable, because of free-rider effects or because the need is not clearly perceived. This means that the revenues earned by viable BDS may finance a number of complementary services which are less viable but which are believed to have a beneficial impact on participating enterprises, or on the market as a whole. In totally commercial settings these services may be offered with a pure profit motive. Usually, service providers wishing to offer non-viable BDS have adopted one of the following approaches to cover costs, or several of them combined; a) cross-subsidize from larger to smaller clients; b) cross-subsidize less viable services using revenues from more viable services; c) obtain income through an unrelated income-generating activity; d) find a supplier or buyer who is willing to underwrite all or a portion of the cost of service provision because this actor will benefit from the improved performance of small enterprises; and (e) use donor or government funds.[5]

11. *Sustainability.* In all these schemes, it is assumed that the delivery of services and their financing are monitored and that the ultimate objective is to reach sustainability. As yet, there is no consensus as to the specific meaning of the term "sustainability" in relation to BDS providers. It might mean that a situation has been reached where enterprises using the BDS are prepared to pay the full cost (direct and indirect) of these services. But there are some who would argue that "sustainability" has been attained when the users cover all the direct costs of a consultancy. In the case of *donor participation*, sustainability can be interpreted as reaching a point where there would be an end to donor involvement, either through the commercialization of services or through an appropriate arrangement for the replacement of donor support by other national or private resources. If BDS must service very small enterprises, this may be a less realistic goal. If this is not attainable, then there would have to be a clear understanding of the justification for long-term support, such as that the services are being offered to a target group that is particularly disadvantaged due to past or prevailing economic, social or political conditions. However, in most cases it is expected that BDS providers, should achieve sustainability, although it has to be recognized that this may take longer than is often envisaged in the planning stages and is probably not achievable in a period of less than 10 years.

12. *Monitoring and performance indicators.* A number of criteria are under discussion that could be used to monitor and measure the performance of BDS at all levels. Monitoring should include regular

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contribution and who have a suitable background and are considered to possess the required commitment to benefit. There have only been a few actual cases of the use of vouchers, and some discussion has taken place on their being used for advisory services as well.

5 L. Goldmark (1998).

evaluation of the direct impact of BDS on the firm as regards improvements in output, quality, profitability and sales. Assessment should also be made of the impact at the meso level, namely, the extent to which reliable and effective institutions have been established or strengthened that are able to sustain the continuation of successful BDS. Finally, some consideration should also be given to the macro-level effect of the work of the BDS, whether there has been an increase in employment, exports or regional development or the introduction of new technologies. More specifically, standard performance indicators should refer to the following qualitative and quantitative aspects: *outreach* (number of individuals, enterprises and organizations reached by a BDS programme); *impact* (on enterprise, market, sector); *efficiency* (cost and rate at which inputs are converted into outputs); *effectiveness* (achievement of overall programme's objectives in terms of development goals and delivery of services of acceptable quality at minimum cost); and *sustainability* (extent to which the service provided can be financed through client fees, degree of duration of the resulting changes in SMEs and degree of self-financing of the organization providing the services).[6]

B. Technology for SME development

13. It is often stated that globalization and liberalization have opened new opportunities for firms in developing countries to acquire technology from abroad and that increased competitiveness in technology markets has made technologies cheaper and more accessible. This may indeed occur in some industries and sectors, while in others technology remains costly and access is still difficult for SMEs in the developing world. Acquiring technologies and the technological capacities needed to master technologies involves time, effort, cost and risk, and complex interactions between firms as well as between firms and institutions.[7]

14. Technology acquisition takes place through various forms, including purchases, franchising, licensing, strategic alliances among firms and technology transfer under technical cooperation programmes. However, effective transfer of technology does not depend solely on accessibility and the terms and conditions for the acquisition of technology, but also on local demand conditions and on the prior building of the technical and managerial capabilities which determine the ability of firms to absorb and master acquired technology. On the demand side, for example, the small size of most firms and markets in developing countries, as well as weak distribution systems and marketing channels and the lack of support structures, are impediments to obtaining technology. These issues are often neglected when policy discussions for promoting the transfer and diffusion of technologies focus primarily on the supply side.

15. Some of the major impediments include lack of local capacity and the skills required to select, acquire, adapt and assimilate technologies, financial constraints and lack of awareness of, as well as

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6 Committee of Donor Agencies for Small Enterprise Development (1997). The Committee has been particularly active in the field of BDS since 1995, and has promoted several conferences and reports on the subject. The first section of this paper largely benefited from the contribution of Jacob Levitsky and from the discussions held at Rio de Janeiro, 2-5 March 1999, during the International Conference on "Building a Modern and Effective BDS Industry".

7 UNCTAD (1995), Science and Technology in the new global environment: implications for developing countries (UNCTAD/DST/8).

relevant information on, available technologies. Few SMEs have the networking and monitoring capabilities that would enable them to access and evaluate technological information. SMEs, be they in developing or developed countries, generally tend to be risk-averse, particularly when it comes to the introduction of innovations based on new technologies. Despite these limitations, new forms of inter-firm technology cooperation are beginning to emerge that involve longer-term mutual benefits and go beyond short-term financial gain. The common feature of these new forms of cooperation is the sharing of capabilities to develop new products, technologies and processes, or to produce and market new products.[8] This is particularly evident in biotechnology and information technologies, where linkages between local enterprises and foreign firms have developed on both a North-South and a South-South basis.[9] Partnerships and networks between firms and research and technology organizations across the South and North-South have also become common. Good examples of this type of network include the Agricultural Research and Extension Network (AGREN), the Rural Development Forestry Network (RDFN) and the Cassava Biotechnology Network (CBN).[10]

16. It should be noted that technology transfer is only part of the process. Learning by firms is broadly considered to be the key to the effective transfer and diffusion of technology and to the strengthening of innovative capability in the firm as the basis for industrial growth and international competitiveness. Learning, however, does not take place in isolation. Rather, from an innovation perspective it is an activity which takes place only when there are interactions among firms and between firms, their suppliers, their clients, local support structures such as R&D and productivity centres, credit institutions, university and policy makers.

17. In effect, this means that Governments must also engage in an ongoing learning process as they endeavour to formulate and adjust policies to stimulate and support technological change and innovation at the firm level and create an environment conducive to learning. It is evident that different firms learn at different rates and that it is not easy for SMEs to pursue innovation strategies. From a policy perspective, therefore, flexibility will be needed in the types of policy instruments used, their timing and sequencing. Policy dynamics - that is, the interaction between policies and dialogue that involves all principal actors in the enterprise development process - will be very useful. So, too, will policy coherence that strengthens and/or attenuates market forces and thus minimizes cross-signals in setting the parameters within which enterprises make decisions about innovation, investment and exporting.[11]

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8 See also UNCTAD (1997) An Overview of activities in the Area of inter-firm cooperation: a progress report (UNCTAD/ITE/EDS/2); UNCTAD (1998) Selected policy issues, measures and programmes on inter-firm partnerships (TD/B/Com.3/EM.4/2); UNCTAD (1996) Exchanging experiences of technology partnership: the Helsinki meeting of experts (UNCTAD/DST/15).

9 See UNCTAD, World Investment Report 1996 (on biotechnologies) and 1998 (on information technologies); and L. Alcorta et al. (1998), on technological collaboration between firms in the Mercosur region.

10 For a detailed analysis of the nature and functioning of North-South research networks, see R. J. Engelhard and Louk Box (forthcoming), "Making North-South Research Networks Work", UNCTAD, United Nations Commission on Science and Technology for Development.

11 L. Mytelka and T. Tesfachew (1998).

CIEDs

UNCTAD's Centres for Innovation and Enterprise Development (CIEDs) are aimed at reinforcing intra-local collaboration for stimulating continuous innovation in SMEs. They can be considered as a novel institutional response to the challenge of promoting technological upgrading in manufacturing firms in developing countries. Basically, they assist SMEs to define their technological problems and subsequently to mobilize the necessary resources for solving them.

CIEDs have developed their own methodology in terms of diagnostic tools, conceived in order to identify real bottlenecks and adequate solutions, but rely on preexisting technology development organizations and business support activities for interventions at the firm level. Only on an exceptional basis they do involve external know-how and expertise, being based on the premise that local technical, managerial and financial resources are already in place and can be mobilized to support a process of innovation.

In sum, CIEDs are a sort of network brokers, which promote synergies and create linkages between firms and the other components of the local innovation system. Support for such programmes - now operational in Côte d'Ivoire, Ghana, United Republic of Tanzania, Zimbabwe and Uruguay - originates with the commitment of both local Governments and international donor organizations.

18. In order to build local capability for transfer of technology and innovation, diverse forms of collaboration, networks and clusters can be useful. These enable firms to share risks and costs and to access markets as well as link small, medium and large enterprises through an exchange of information (for example, of a technological or marketing nature) and commercial relationships. As a matter of fact, with a growing number of SMEs having the potential to participate in the international market, inter-firm cooperation has shown its effectiveness in contributing to a firm's ability to adjust to the new international competitive environment.

19. The agreement entered into between an Argentine pharmaceutical company (ELEA SA) and Cuban R&D institutions - the Centro de Ingeniería Genética y Biotecnología (CIGB), the Centro de Inmunología Molecular (CIM), the Centro Nacional de Biopreparados and the Finlay Institute - provides a successful example of South-South cooperation. These Cuban institutions had developed a strong R&D and industrial capability but faced enormous barriers to marketing their products. Though this agreement was centred around the marketing by one partner of products developed and produced by the others (ELEAS sales of antimeningitis vaccine produced in Cuba reached US$ 1.1 million in 1997), the technical capabilities and financial support of the Argentine partner allowed the Cuban partner to undertake tests of the vaccine that are likely to strengthen its market prospects in Argentina and elsewhere. As a matter of fact, CIGB agreed to market various biopharmaceuticals it produced in Argentina exclusively through ELEA. Most interestingly, ELEA and CIM entered into a research agreement to develop and market an anti-cancer product, based on technology originally developed by CIM. Based on a network of Argentine research institutions and specialists, a project was set up in Argentina in order to undertake the different phases required for the finalization and approval of the new product by the health authorities.

20. Technical and commercial support structures, such as R&D laboratories, technology transfer centres, quality control facilities and export promotion agencies, should also be supported or developed. These should be designed to provide information on available technologies and ensure an effective transfer of these technologies to SMEs. Support structures building on existing initiatives can create a framework within which the necessary identification, assessment, adaptation and post-transfer follow-up could take place. These can ensure that transfer of technology adds to technological capacity in both local firms and research and technology institutions and promotes the necessary interaction between them to stimulate and sustain a process of innovation. The specific nature of such support structures, including the participation of public and private sectors, would depend on the level of development and technological capacity in each country.

C. Facilitating access to information and telecommunication technologies[12]

21. Information and telecommunication technologies (ICTs) have been diffused to all economic sectors, including primary commodities, manufactures and services. The spread of these technologies, which has accelerated since the early 1980s, and their increased adoption by firms in production sectors has altered the system of production and organization of work and has affected employment and international competitiveness. The results include quality improvements and cost reductions. ICTs have also contributed to making the comparative advantages of low labour costs a relatively less important determinant of competitiveness, which has far-reaching consequences for developing countries. Overall, ICTs have created challenges for all firms, particularly as regards the availability of suitable software, lack of standards, shortage of managers and personnel and the massive investment required by these technologies.

22. As advanced ICTs become more widely accessible and interlinked, a vast new range of applications is emerging. This is providing new opportunities for the generation and management of information that can be tailored to users' needs and contribute to the attainment of development goals. In spite of falling costs and new entry opportunities associated with software development, most ICT innovations and applications take place in the industrialized countries. Only a few newly industrializing and developing economies have become part of this trend over recent years, by developing at an early stage capacities in this field. Thus, countries or economies such as China, Malaysia, the Republic of Korea, Singapore and Taiwan Province of China have become successful in producing ICT hardware. Other developing countries such as India and several Latin American nations have found ways to exploit software development markets.

23. The Internet has been promoted as a means for developing countries to join the global information infrastructure (GII). Although estimates

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12 This part of the paper draws on previous UNCTAD work in the area of ICTs, including: UNCTAD (1995), *Information technology for development - ATAS X Bulletin* (UNCTAD/DST/10); UNCTAD (1993), *Information technology and international competitiveness: the case of construction services in industry* (UNCTAD/ITD/TEC/6), as well as on the work undertaken within the Commission on Science and Technology for Development, including the Report of the Working Group on ICTs for Development (E/CN.16/1997/4,1997) and *Knowledge Societies: Information Technology for Sustainable Development*, publication for and on behalf of the United Nations, Oxford University Press, 1998.

of the rate of growth in the use of the Internet are very high, the highest growth rates are concentrated in the industrialized countries. Some data indicate that about 90 per cent of the users are from the highest-earning and most educated strata of the population. Overall, access to ICT networks and services and the use of ICT equipment in the developing countries and countries in transition are still very limited compared with the industrialized countries. This is especially true of the least developed countries and the rural areas of countries in sub-Saharan Africa. To cite just a few examples, in 1998 the rate of Internet usage reached 0.01 per cent of the total population in Paraguay, India and the Philippines, and 2-2.5 per cent in Taiwan Province of China, republic of Korea and Kuwait, whereas it reached 6.5 per cent in France, 9.6 per cent in Japan, 18 per cent in Australia and 35 per cent in Finland.[13]

24. Potentially, smaller firms could be the most significant winners in the emerging global information economy. That is, of course, provided that the quality and competitiveness of their products meet international standards. Electronic commerce in particular offers SMEs unprecedented possibilities to compete on global markets and to weave strategic and networking alliances with other players around the world. The "death of distance" provides new possibilities for inter-industry trade, cross-border partnerships and strategic alliances. Internet-based electronic commerce offers cost-effective possibilities for SMEs to advertise their products and contact buyers and suppliers on a global basis.

25. However, such potential may remain out of reach for many SMEs - especially in developing countries - if a certain number of pre-conditions are not met and skills provided. Among these are: access to reliable and cost-effective telecommunications infrastructure; ability to master IT and e-commerce techniques; ability to introduce national content in the dominant Anglo-Saxon business models; and ability to provide effective guarantees for payments and safeguards against defaults. As a matter of fact, ICT diffusion largely depends on skills to operate systems based on these technologies as well as the capacity to absorb and manage them. Effective use of ICTs requires the introduction of software and digital equipment along with a profound transformation in the internal organization of the enterprise and its interconnections with markets and suppliers. The absorption of ICTs involves not only technical capabilities but also effective planning and organizational abilities.

26. Coherent measures and activities consistent with national development strategies are necessary to cope with the above problems and to assist the access of SMEs to ICTs in developing countries and economies in transition. Effective planning, organizational capabilities and related managerial skills with regard to ICTs are, for example, critical at the level of the enterprise. At the industry level, the establishment of electronic networks, common databases and various value-added services, which speed up transactions are fundamental. Governments have substantial scope to influence the development of a local ICT industry and the promotion of ICT diffusion through, for example, standard-setting, outsourcing and application of competition policies. Measures such as legal protection for confidential information, security for electronic transactions, and standards create an enabling environment for introducing ICTs.

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13 For further data on the Internet connectivity and usage in developing countries, see UNCTAD (1998) "Policy issues relating to access to participation in electronic commerce", TD/B/COM.3/16.

CHAPTER II

FINANCIAL SERVICES FOR SME DEVELOPMENT

A. Main obstacle to finance

27. Having recognized that limited access to credit by SMEs is a major constraint on production and growth, many Governments directed public funds to SMEs through specialized financial institutions, such as agricultural and industrial development banks. In addition, commercial banks were encouraged to lend to this sector through loan quotas, subsidies, tax breaks, and guarantees against defaults. Despite massive subsidies, development banks created by Governments in developing countries have had little success in reaching the intended beneficiaries. Many development finance institutions (DFIs) have been unable to operate profitably with SMEs as their sole debt clientele; others have become either subsidy-dependent or insolvent because of managerial and strategic difficulties.

28. Some experts have argued that the failure of directed credit programmes resulted from the limited role of market forces in determining interest rates and a lack of savings mobilization in the design of the credit programmes. In addition, in the countries that lack active and organized capital markets, experienced intermediaries and a favourable regulatory environment, local SMEs have difficulty raising the medium- and long-term capital. As a result, most SMEs rely on their own capital to start up and sustain their activities. For example, between 59 and 98 per cent of SMEs in African countries use their personal assets to capitalize their enterprises.[14]

29. There are also few successful examples of DFIs that have proven able to operate profitably with SMEs - among these, the Corporación Andina de Fomento (CAF), a private multilateral financial institution which promotes sustainable development and regional integration by attracting capital resources for the provision of multiple financial services to the public and private sectors of the shareholding countries. After a process of radical internal reforms, in 1997 CAF attained the highest level of approvals in its history (US$ 2.9 billion) and also the highest level of net profits. It expanded and diversified its operations geographically, approved an emergency programme to finance reconstruction projects required after the disasters caused by El Niño, and placed the most competitive bond issues with respect to spreads and term structure in the U.S. market.

30. It should be noted that the commercial banking sector generally displays little interest in SMEs because small loan size, high transaction costs, lack of tangible collateral, and an absence of good financial data all make risk evaluations of SMEs costly and difficult. In addition, the banks lack the expertise to efficiently evaluate a project's potential and the borrower's loan repayment capacity. Two other elements also contribute to the reluctance of commercial banks to lend to SMEs: SMEs' high rate of bankruptcy, and heavy dependence on a single individual - the entrepreneur. As a result of all these factors, SMEs cannot secure bank loans on satisfactory terms and instead receive largely short-term financing for meeting long-term needs.

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[14] UNCTAD (1995) "Issues concerning SMEs' access to finance".

B. Financial services available and their limits

1. The formal financial services sector

31. The formal financial sector exhibits the following impediments in growing SMEs' access to capital:

- low profits or losses when dealing solely with SMEs;
- an incomplete market for financial instruments, especially for longer-term debt;
- long lead times, from long negotiations and processing to approval;
- slow response to varying needs due to environmental changes;
- non-customized financial products; and
- services for individual SME needs.

These obstacles are exacerbated in developing countries with poor financial capital markets, financial intermediaries which often lack the requisite expertise or unstable regulatory and political environments.

2. The informal financial services sector

32. Informal finance plays a large role in financing SMEs in developing countries. It includes capital from individual moneylenders, mutual savings and loan associations, and partnership firms. The informal financial sector is characterized by:

- flexibility and speed;
- high transactions costs;
- exorbitantly high interest rates (e.g., 192 percent in Nigeria);
- small loan size of short terms; and
- high repayment rates due to applicants being more closely screened, strict monitoring of loans, proximity to lender, and peer pressure.

3. Separate financial institutions and development banks

33. Many countries have established separate financial institutions to provide credit exclusively to SMEs. The performance of special financial institutions for SMEs and development banks is characterized by:

- poor profitability;
- high administrative costs due to state ownership;
- horizontal expansion of services to include technical assistance, training, etc.;
- expansion of services to include large-enterprise loans;
- dependence on government subsidy, dissolution or liquidation.

4. Guarantee schemes

34. Many Governments and international financial institutions have established guarantee schemes to encourage the commercial banks to lend to SMEs by furnishing them with guarantees against default. Often a premium of 1 to 3 per cent is charged against guarantees of up to 80 per cent. To date, the experience with SME guarantee schemes has been mixed. Some have failed and few have succeeded. One major problem has been sustainability over the long run, in particular, since most funds are

capitalized by donors or Governments. Most guarantee funds cover investments in production facilities and few are prepared to guarantee the financing of working capital. In many cases SMEs have been granted financing for investment but have not been able to raise funds to implement the investment because guarantees for the financing of working capital were considered too risky.

TABLE 1
Guarantee schemes

Advantages	• Encourages banks to lend to SMEs which otherwise would be denied • Longer-term loans and lower collateral requirements • Less harm than providing lenders with cheap, subsidized funds
Observed problems	• Banks are reluctant to share risk - an overly accommodating attitude on the part of the banks leading to high rates of defaults • Lack of timely announcement of overdues by banks • Time-consuming and inefficient handling and settlement of claims • Dependence on soft funds - most guarantee schemes rely on state subsidy/intervention • Cumulative costs of the loan and guarantee are generally exorbitant • Need efficient and strict management and investment capacity • State-run guarantee funds often lack professionalism and rely on the state to cover losses

5. Leasing

35. Financial leasing is a contract agreement that allows the SME to use an asset in exchange for periodic payments to the lessor. Because the leasing company retains asset ownership, lease payments are an operating cost rather than a financing charge. The leasing company relies on the ability of the SME to generate cash flows, rather than relying on its assets, capital base or credit history. Typical lease arrangements require 10 per cent of the asset cost as security and terminate after three to five years. Leasing has proven to be an innovative means for SMEs to access mid-term capital. Moreover, SMEs in developing countries benefit from the technological transfer in addition to mid-term financing. Leases have been provided to SMEs for assets such as looms, production line equipment, and solar energy systems.[15]

TABLE 2
Leasing

Advantages	• Costs of acquiring financial and historical data on SMEs are lower • SMEs face less stringent collateral or security requirements • Leases are arranged more quickly than conventional loans • Enterprises can access lease finance more easily than bank loans • Defaults have been minimal, with lessors reporting default rates of 2 to 7 per cent
Observed problems	• Leasing serves only a modest percentage of SMEs, excluding those using traditional means of production or specialized equipment • Specialized companies must often be established for lease procurement

6. Venture capital funds

36. Venture capital is an investment mechanism that provides both equity capital and managerial assistance to emerging companies. As target companies develop new products and services, venture capital firms (VCFs) finance their start-up, expansion or acquisition costs.

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[15] Gallardo, Joselito. (1997) "Leasing to Support Small Businesses and Microenterprises".

Venture capital is proliferating as a source of equity for SMEs in emerging markets, with some funds receiving initial capitalizations of as much as US$500 million. Because the growth in venture capital is a recent phenomenon, it is too early to evaluate the performance of most funds. Early reports, however, suggest that most venture capital funds have performed poorly. Their failure has been attributed to a lack of competent management and a lack of investment opportunities. Two ways to improve venture capital funds would be a fine-tuning of management and better communication between SMEs and VCFs.

TABLE 3

Venture capital funds

Advantages	• Provide flexible, long-term equity capital • Small, customized equity injections are made for each SME • Managers participate in the operation and administration of the SME • Funds often evolve to provide SMEs with other financial products, such as lease, working capital, and export financing
Observed problems	• Many venture capital initiatives perform poorly. For example, venture capital funds of the International Finance Corporation (IFC) reported returns between minus-1 and 5 percent per annum in the 1980s[16]; many VCFs sponsored by the United States Agency for International Development have become insolvent or were liquidated[17] • Countries without active stock markets do not provide the opportunity for high return and liquidity that VCFs seek • Inefficient and inexperienced fund management • Finding managers for VCFs in developing countries is a major challenge as reported by the experiences of the IFC • Slow deal flow; not all fund assets are employed since fund managers are unaware of SME investment opportunities • Lack of awareness by SMEs of venture capital funds • Entrepreneurs in developing countries are reluctant to share ownership with external financiers • Difficulty in attracting the right resources and right clients; investors are unaccustomed to investing in funds managed by others which focus on risky small businesses • Difficulty in exiting investments in countries with undeveloped capital markets

7. Inventory financing

37. Inventory financing enables a company to increase its short-term capital and thus improve the conditions for earnings growth. Also known as factoring, inventory financing used to cover working capital based on the cyclical needs of a business or used to build up inventory one time in the year, for liquidation later in the year, or to sell over the course of the year. When inventory is used as collateral, financing is generally around 50 per cent of current replacement cost.

TABLE 4

Inventory financing

Advantages	• Inventory is used as collateral • Allows a company to buy goods at an advantageous price or time • Permits year-round production of a seasonal product • Easier access than bank loans
Observed problems	• SMEs must be able to provide cash flow forecast, operating budget, and inventory turnover figures • Specialized companies must often be started to provide factoring • Poor quality of inventory

[16] Carter, Lawrence W. et al. (1996) "Investment Funds in Emerging Markets."

[17] United States Agency for International Development (USAID). (August 1996) "The Venture Capital Mirage: Assessing USAID Experience with Equity Investment".

C. Lessons from microcredit

38. The obstacles often associated with microenterprise lending - high costs, low returns, a lack of standardized financial disclosures and an absence of collateral - also limit SMEs' access to commercial banks. Over the past 10 years a new breed of financial institution has emerged at the grassroots level. Microfinance institutions (MFIs) specialize in reaching microentrepreneurs and are mostly unregulated, non-profit organizations. Through innovation and experimentation they have developed techniques for profitably providing financial services to microentrepreneurs on a previously unthinkable scale.

39. To achieve sustainability and growth, these institutions practice commercial but non-traditional lending. They have concentrated their efforts on developing lending products, refining credit technology, and reducing the arrears and administrative costs associated with lending to microenterprises. In sum, the key factors that have led to the success of microcredit programmes are: a) rapid response; b) exposure to competition; c) customization of service; d) knowledge of clients' needs; e) client participation; and f) experience.

40. The underlying reason for this success is that MFIs are close to the clients. With a market perspective, MFIs understand the preferences of the client group and design products to meet them. Despite the fact that MFIs are frequently run in an informal manner and are often unknown to formal financial markets, their repayment rates are very high (97 per cent). This is due largely to their operation at the grassroots level and reliance on social and peer pressure to ensure reimbursement. Proximity to applicants allows them to better evaluate needs and risks.

TABLE 5

New techniques in microfinance

Non-traditional approaches to lessen risk	Reduced transaction and administrative costs	Market-based pricing
→ Motivation-to-repay techniques replaced collateral requirements or time-consuming and costly analysis → Clients are given the motivation to repay through peer pressure and the promise of ongoing and increasing access to credit	→ Simplified and decentralised loan applications, approval, and collection processes → In group lending programmes, the borrowers themselves perform the approval process, screening each other and approving credit with permission from the group	→ Lending rates are based on market rates rather than subsidies → For most micro-borrowers the cost of not having access to credit is greater than the interest cost of borrowing, which allow MFIs to cover costs associated with small lending

41. These discoveries by MFIs have not come without cost, however. In its 1989 review of financial systems in emerging economies, the World Bank claimed that many MFIs in developing countries are insolvent, and some have actually failed.[18] Their failure or dependence on subsidies often occurred because funding agencies often included institutions in microfinance projects that did not have a clear prospect of achieving

[18] World Bank (1989) "World Development Report 1989".

full financial sustainability in the medium term.[19] MFIs that were also government agencies tended to suffer from rapid turnover in personnel, discontinuity in leadership and mission definition, and procedural rigidities. Moreover, institutions not backed by the private sector often lacked the financial management skills that MFIs need to be successful. Government credit-directed schemes often diverted portfolio funds to microenterprises with high default risk and low returns.

42. Although SMEs' medium- to long-term financial needs differ from the rapid, short-term credit needs of microenterprises, there are lessons that could be useful in improving SMEs' access to finance. One important lesson may be to provide financial services to *clients* rather than to *beneficiaries*. Moreover, moving from *subsidized services* to sustainable *market-priced services* could serve clients better in the long run. Financial service providers to SMEs should also consider transferring the burden of loan analysis to the clients by group lending, as well as establishing a credit rating system.

43. The success of microcredit programmes has taught DFIs that lending programmes should be run as businesses and not as charities. Their success has also laid the groundwork for innovative lending schemes that could be envisaged in the case of SMEs, such as group lending and reducing default risk through incentive-based enforcement mechanisms (e.g., peer pressure, linking savings with credit, and promises of continued credit). The primary business of formal financial institutions, ranging from commercial banks to venture capital companies, is to make money by providing financial services. Their survival and expansion depends on profit maximization, and a professionally managed institution will forever shy away from businesses when it cannot evaluate their risk and return potential. Solid business decisions cannot be made in the absence of reliable and transparent information. If the repayment of loans is not secured, the sustainability of the financial service will always be jeopardized.

44. Thus, the importance of reliable financial information cannot be understated. Reliable and transparent data on SMEs are essential in facilitating access to finance, since such data exposes their potentials, risks and needs. For creditors, investors and guarantors to allocate capital, they need access to reliable information. The cost of acquiring this information for SMEs is high because the language of business communication - accounting and reporting - is not standardized. In many countries the accounting and reporting rules for SMEs were developed for large or listed companies. SMEs need rules for accounting and reporting that are sufficient for creditors, investors, tax collectors and managers, but are not overly burdensome. An international system for accounting and reporting by SMEs is needed.

CONCLUSIONS

45. While financial services are often identified as the major development constraint to the SME sector, other services are also needed. The more traditional markets are saturated and new skills, new markets and new technologies are needed, more credit alone may fall short in promoting the growth and development of SMEs. Finance can solve liquidity problems or generate the expansion of existing activity, but it can hardly increase productivity, operational efficiency and competitiveness. If small producers are to take advantage of the opening up of higher value-added market niches, and eventually to move from

[19] Asian Development Bank (1997) "Microenterprise Development: Not By Credit Alone".

producing by "imitating" to producing by introducing continuous innovation and change, then complementary business and technical advice are needed.

46. Since the mid 1990s, there have been innovations in the design and delivery of BDS. Experience shows that these can be made more cost-effective and have a greater impact than before. The adoption of principles of good practice, such as those of *subsidiarity* and *sustainability*, have proven crucial in this respect, as has a greater use of market mechanisms. This means that an ideal BDS support intervention would use and strengthen existing private-sector service delivery capacity, stimulate a market for BDS, operate in a businesslike manner and ask the clients to pay at least part of the cost of the services. In addition, such an intervention would be:

- demand rather than supply-oriented;
- decentralized rather than centralized;
- targeted to local clusters rather than to individual enterprises.

47. In particular, technology transfer and diffusion have proven critical to strengthen innovation capacity in SMEs but also to stimulate the creation of a local and international market for their products and - consequently - for BDS services. Transfer and diffusion of technology alone will not enable local firms to sustain a process of continuous change because it is extremely costly and risky to buy-in technology, especially in developing countries. Building up the local capacity and stimulating synergies that support innovation in the SMEs sector are critical. This process can also be facilitated by the creation of technology centres to carry out development work on basic research results produced by universities, entrepreneurial promotion schemes, government incentives for innovation, venture capital funds for high-tech firms and specialized research and training facilities at the sectoral level.

48. Governments must also improve the technology infrastructure - particularly telecommunications - if SMEs are to take advantage of the opportunities opened up by information and communication technologies. According to recent data on Internet connectivity, the diffusion of information and communication technologies in developing countries clearly requires strong state support. This role is particularly important in the following four areas:

- competition policies (stimulating open competition in basic telecommunications services and Internet access);
- training (offering possibilities to nationals to receive vocational training in enterprises already active in e-commerce);
- the emergence of a local e-commerce culture (re-inventing and adapting e-commerce features and rules, rather than importing them, in order to be truly adapted to local SMEs needs);
- the creation of cross-sectoral "circles of trust" (involving all trade-supporting players - such as exporters, importers, banks, insurance companies, customs, transport companies, telecommunications services providers, trade facilitation bodies and chambers of commerce - in local "circles of trust", provided that trust becomes an essential element of success. when trade relations and contractual commitments become electronic).

49. Finally, much still has to be done to increase the flow of finance to SMEs and to overcome traditional inherent difficulties (mainly, high transaction costs and lack of collateral). As a matter of fact, in most developing countries the lack of information on SMEs stifles the efforts of DFIs to assess investment opportunities and financing needs. In addition, the absence of accounting information makes it difficult to

assess SMEs' potential and risks for both loans and investments. It is also difficult for SMEs to raise capital in equity markets, particularly venture capital funds, because of the lack of financial information and a track record.

50. Among the measures which could improve SME access to finance are:

- efficient information-gathering, analysis and dissemination;
- standardized financial disclosures;
- SME rating;
- matching of needs with financial instruments;
- a presence of active local capital markets;
- critical mass of entrepreneurs who could provide sufficient returns to venture capital fund.

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